No. 16995
IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Los Angeles Trust Deed & Mortgage Exchange, Trust Deed & Mortgage Exchange, Trust Deed & Mortgage Markets, David Farrell, Oliver J. Farrell, Thomas Wolfe, Jr., and Stanley C. Marks,

Appellants,

vs.

Securities and Exchange Commission,

Appellee.

Reply Brief of Appellants Trust Deed & Mortgage Exchange, and David Farrell.

Paul J. Foley,
Woodward Building,
Washington 5, D. C.,
(NAtional 8-1111),
Attorney for Appellants Trust Deed & Mortgage Exchange and David Farrell.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX

TABLE OF AUTHORITIES CITED

No. 16995

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Los Angeles Trust Deed & Mortgage Exchange, Trust Deed & Mortgage Exchange, Trust Deed & Mortgage Markets, David Farrell, Oliver J. Farrell, Thomas Wolfe, Jr., and Stanley C. Marks,

Appellants,

vs.

Securities and Exchange Commission,

Appellee.

Reply Brief of Appellants Trust Deed & Mortgage Exchange, and David Farrell.

I.

Basic Jurisdiction of SEC Not Established.

Since it is candidly conceded that this is a "test case", (SEC brief 28) coming some 25 years after the enactment of the statute which is involved, it must be realized that the bona fides of the case necessarily are suspect for that very reason. This is not a situation in which the type of instruments involved came into being recently. Mortgages and Trust Deeds were in use for centuries and common and well-known at the time of the enactment of the basic statutes here under construction. Nowhere does the SEC establish exactly how the subject matter of the appellant's business falls within the legal standards for securities which are the only area of jurisdiction for the SEC.

A. SEC Evades Use of the Legal Standard for "Investment Contract" and Seeks to Create a New One

Almost mute as to the precise illuminating standards set forth in the controlling *Howey* case, (328 U. S. 293), SEC attempts to grasp certain general language from the earlier *Joiner* case (320 U. S. 344) and use it as the springboard to vault into the nebulous area of concluding that an "investment contract" is anything that SEC thinks an investment contract is. (See SEC brief 36). Rather than using the precise standard set forth in the *Howey* case, SEC wants to substitute the nebulous standard of anything which looks like security (to SEC) must therefore be a security. As previously pointed out in page 19 of my opening brief, the SEC on another occasion properly represented the definition of an investment contract to another Circuit Court, after citing most of the cases on the point, as follows:

> "A common denominator in all these (investment contract) cases has been the fact that in each instance, the managers of the enterprise used some of the money supplied to them to perform services which were for the common benefit of all investors, all of whom shared in the profits or losses from these services, and the return was not a sum certain but fluctuated in direct relation to the success or failure of the enterprise. The tangible items sold were part of a contract under which the manager sought to employ the money paid so that each contract holder would share *pro rata,* in proportion to his payment, in the fruits, if any, of the management's services."

Completely abandoning this standard which is the theme of the precise definition of the *Howey* case,

r the SEC now urges that a new definition of an
ment contract be created so that merely because
tl fact that certain properties had anything in com-
n nd there were any servicing involved, an invest-
n contract would result. The horrible and over-
hing impact upon our total economy of such a con-
n is apparent if we analyze just a few of the
r day transactions which obviously were never in-
il to be "securities" but would fall within the
nebulous SEC concept for "investment contracts"
rged.

St of all, it is basic in real estate that any parcel
l of land has something in common with many
e parcels, usually those which are close to it. All
g, school district regulations, utilities (whether
rative or not), streets or highways and other de-
nents, industrial or commercial, in the area are all
cteristics which individual units of real estate in
ea have in common with their neighbors. A com-
y of interest therein exists. This is imperative in
ery nature of real estate and particularly, in the
unity development of real estate. This is true
er it is rural, urban, or even totally undeveloped
Further, from contracts for streets, utilities, water,
elephone whether created by the voluntary vote, in-
dent contract, action in the nature of condemna-
r eminent domain, the same result obtains, namely,
is to numerous items a community of interest in
and every parcel of real estate in relation with
ent properties. Other typical examples are water
, repairing rights, and frequently lawful liens
st entire communities which arise either by con-
or governmental action in connection with streets

and other utilities. Thus, at least, every developer would be selling individual lots having far more community of interest than in appellant's business.

The mere fact that properties have something in common with each other does in no wise meet the standard set out in the *Howey* case, *supra,* which in its precise terms provides as follows:

> "An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."

SEC would have this requirement distorted into a provision that an investment contract could be created where there was merely something in common between the property purchased by one customer with that of the property purchased by another customer. Moreover, it will be noted that the Howey definition of an investment contract requires not only the investment in a common enterprise, but also sole reliant upon the efforts of the promoter for profits. The SEC never did get around to showing how the customers of LATD relied solely upon the efforts of the promoter (LTD) for the profits, particularly for the reason that there weren't any profit participations. The customer got merely what the trust deed contract called for. There is no manner of participation in profits resulting from the efforts of the promoters, solely or otherwise.

If the nebulous standard now urged by SEC had any merit to it, it would mean that every cooperative apartment, for example, which was offered would constitute an investment contract. Although each customer buys a particular unit within a cooperative apartment,

ely it has far more in common than anything which
sold by LATD in the form of a trust deed. More
icularly by its very nature, the cooperative apart-
t has certain cooperative services for which the
ner of the individual apartment must rely upon man-
nent. Irrespective of whether the purchaser of a
perative apartment occupied it or rented it, the very
that ultimately he would of necessity have to dis-
of it and, in that sense, would get a profit or a
on the SEC new, loose standard, the arrangement
uld have to be an investment contract. Frequently
blket mortgages exist on cooperative apartments.

Of course, that is but one example, and the same
ng could be extended to cover a large segment
all properties merchandized in our economy. For
mple, certainly the purchaser of any new auto-
bile has something in common with other purchasers
the same make of automobile, and as SEC urges in
case, a customer is somewhat reliant upon the
dor company remaining in business. This argument
equally applicable to vendors' cars, refrigerators,
shing machines and virtually all of our manufactured
ds, as well as many other types of properties which
trafficked in our economy. Thus, if such a sale
uld be coupled with a service of warranty contract,
enever a sale occurred in which the vendee intended
se it in business, rent it for a profit, or otherwise
t it as something from which he expected to de-
income or return, it would fall within the loose
ndard urged by SEC for "investment contracts".

Other obvious examples of ordinary transactions
ch SEC would attempt to blanket within its new,
se standard for the "investment contract" are many

transactions regularly made by real estate brokers. More particularly, any offering of a property to a potential real estate customer for purposes of his renting said property with said rental being managed by the real estate broker would, if the SEC's new standard had any validity, bring the transaction within the "investment contract" definition. So on, the loose standard urged could be applied to a substantial percentage of all of our commercial transactions which have nothing to do with the securities field.

Since rental or leasing of industrial equipment has become so prevalent, it is also obvious that the acceptance of SEC's new version of what constitutes an investment contract would permit it to invade the entire field, since there a company buys equipment from a vendor who warrants and agrees to service said equipment and the vendee corporation expects to derive its income from the rental of said machinery or equipment. Obviously, of course, this group of industrial transactions do not fall within the Howey definition or any lawful definition of investment contract, but it would fall within the loose and nebulous standard now urged by SEC.

The SEC is practically mute on the point of the second requirement of an investment contract having to do with sole reliance upon promoters for *profits*. Nowhere in its brief does it precisely show that there is any participation in profits or, in fact, that there is anything that the customer of LATD anticipates other than getting the precise contractual obligations according to the terms of the trust deed which he bought, totally free and devoid of any profits or losses which LATD might have incur. Furthermore, there certainly is not

reliance upon LATD. The principal reliance of the omers of LATD must necessarily be upon the oc- uants of the home, owners of the land and makers the trust deeds which are involved.

s to the moderate servicing which LATD did offer, best efforts basis to do for its customer, it must bointed out that this type of servicing is character- in the entire mortgage field. (See the national uations of the national mortgage markets contained he typical issues of House and Home Magazine, J and K, wherein the mortgages quoted in the onal market are quoted *with the servicing* char- eristic in the mortgage field. Certainly these char- eristic and modest services which are usual in the tgage industry do not bring the entire mortgage stry and the morgage market suddenly within the sdiction of the SEC and it certainly was never in- led that SEC be permitted to invade the mortgage d on this pretext. Yet LATD did no more than al in the mortgage field. The moderate servicing in- ed falls short of one standard required by the Su- me Court and delineated in the *Howey* case to wit, nvestor) is led to expect profit solely from the ef- s of the promoter or a third party."

he vice involved in contemplating the acceptance of ew, loose standard suggested by SEC for invest- t contracts is that through the use of it, SEC would permitted to invade a vast segment of our entire omy under the pretext that an ordinary contract stituted an investment contract. Certainly, this was er the purpose of the term as used in the original . The very fact that it has never been so applied mortgages in the 25-year history of the statute

should stand as ample proof that it was never intended, and should never be permitted, to occur. Business at best is somewhat uncertain but if the loose standard advocated by SEC actually were adopted by this Court and did become law, the result would be that SEC would have in its hands an instrumentality with which it could bedevil almost any business organization which it singled out for abuse, and the status of the businessman would be subjected to peril and intimidation probably unknown since the days when the Bastille stood in Paris as the very symbol of oppression, ready to decapitate all of those who did, or were thought to, oppose it. The monstrous result of the SEC activity in this case is proof enough that it is not above flagrant abuse of its jurisdiction and its prerogatives irrespective of the havoc, ruin and calamity which its own impetuous and unwarranted action creates.

In explanation of appellants' disinclination to quote the *Joiner* case, the Supreme Court in the *Howey* case (a later case) had this to say at 328 U. S. 299 after stating the definition of "investment contract" upon which appellants' rely: "Such a definition necessarily underlies this Court's decision in *SEC v. Joiner Corp.* 320 U. S. 344, and has been enumerated and applied many times by lower federal courts. *Atherton v. U. S.*, 128 F. 2d 463; *Penfield Co. v. SEC*, 143 F. 2d 746; *SEC v. Universal Service Assn.*, 106 F. 2d 232; *SEC v. Crude Oil Corp.*, 93 F. 2d 844; *SEC v. Bailey*, 41 Fed. Supp. 647; *SEC v. Payne*, 35 Fed. Supp. 873; *SEC v. Bourbon Sales Corp.*, 47 Fed. Supp. 70; *SEC v.* 12 *Fed. Supp.* 245; *SEC v. Timetrust Inc.*, 28 Fed. Supp 34; *SEC v. Pyne*, 33 Fed. Supp. 988. The Commission has followed the same defini-

in its own administration proceedings. *In re Natural Resources Corp.*, 8 S. E. C. 635."

Yet despite the clear and controlling definition set forth by the United States Supreme Court, the SEC now wants to rely on the general language and dictum of an earlier case (*Joiner*) for the reason that SEC cannot successfully apply the *Howey* test to the appellants' sales of trust deeds.

Recognizing its inability and failure to apply this Supreme Court test, the SEC had inserted in the Findings, [F. 46 lines 9-10] after a long rambling tribe, the startling assertion that the elements of an investment contract are not amenable to characterization in absolute term," and then the lower court found "categorically" that the defendants were dealing in "investment contracts". Thus SEC arrives at home base without any attempt to tag first, second, or third base.

In summary therefore, it is clear that in the SEC brief and in the trial, it was nowhere shown that the customers of LATD were "(investors) led to expect profit solely from the efforts of the promoter or a third party." Nor was it shown that a customer of the LATD was "a person invest(ing) his money in a common enterprise." All that SEC has shown is that some of the trust deeds sold by LATD had some common characteristics with other trust deeds sold by LATD to different customers, however, that falls far short of the standard set up by the Supreme Court as to what constitutes an investment contract. Since each customer held an individual trust deed the type of community interest required by the *Howey* case did not exist. Moreover, SEC didn't even attempt to answer how

the LATD customers were led to expect any profits solely from the efforts of LATD since obviously there were no profits involved and all that the LATD customer could anticipate was the performance of his individual trust deed contract by the maker thereof or his successor in interest. It would be a travesty upon our economy to permit the SEC, after 27 years, to get an entirely different and loose standard whereby they could arbitrarily invoke their jurisdiction over vast area of our entire economy where it was never intended to be applicable.

B. SEC Cannot Answer Overwhelming Proof That Simple Mortgage Including Note, if Any, Is a "Security" and Desperately Attempts Big Bluff by Calling Controlling Legislative History "Frivolous."

The blunt and unescapable truth is that despite the fact that over 1,000,000 new mortgages come into existence each year for non-farm properties and the SEC Act has been on the books for almost 27 years, not one *simple home mortgage has ever been registered* or itself the subject of any litigation wherein it was alleged to be a security under the SEC Act. Throughout this trial, the SEC has continuously alluded to certain mysterious registrations of simple home mortgages as securities. It did this throughout the trial in the District Court and in response to the questioning by this Court. It is now patently clear, however, that at no time has any such security ever been registered. It is true that Mason Mortgage Company has registered a certain formal independent guarantee which obviously is itself a security, but even in the Mason Mortgage situation there is no attempt even made to register individual mortgages. In this regard SEC mys-

viously alluded to certain exemptions, but this Court ll knows that as to the horde of some 25,000,000 rtgages of all types and characters issued in metro-itan areas which overlap many state boundaries, it impossible that a large percentage of them are either trastate or privately offered since they are offered ely in newspapers and other periodicals and by ns and openly offered to all comers. Moreover, many them involve unimproved property, industrial prop-ty and all sorts of properties which couldn't con-vably come within the exemptions which SEC fre-ently alludes to in mysterious terms. The blunt and escapable truth is that in 27 years there has never en a mortgage with or without the individual note ich sometimes goes with it, ever considered as a se-rity for the purpose of registration or for purposes any other type of litigation involving the SEC. The islative history of the basic Act makes it very clear t it was never the intention of Congress to in any-se permit the SEC Act to overlap into the home rtgage field.

Neither the basic statutory definitions, nor the gulations which have been issued continuously by the C over the 27 years of its administration of these ts have ever, in anywise, indicated that a simple home rtgage, with or without the attendant note, if any ould be considered a "security" under the SEC Act's finition clause. The regulations are crystal clear that curities become involved only with the multiplicity of lividual participations under a blanket mortgage. The ening brief is so clear and well documented on this int, it will not be repeated here but suffice it to say at in no manner has SEC been able to face up to is overwhelming legislative history and regulatory

practice which is consistent with the practice f industry and commerce in these areas of our econ y.

Almost ludicrously, SEC tries to misapply a basic section of our United States Code which indicat that wherever a contrary intent is not indicated, the us of a singular or plural may be interchanged; howeve this has no application whatsoever in instances where te use of the singular or the plural has a particular in lication and purpose and it is most obvious and iport- ant here.

In *First Natl. Bank v. Missouri,* 263 U. S. 0 at 657, the Supreme Court clearly held that des te 1 U. S. C. 1 the singular and plural are not to be nter- changed except when required, and are not to be nter- changed when a reason for the distinction is e dent, in the following language:

> ". . . Strictly the latter provision, employ g as it does, the article 'an' to qualify words the singular number, would confine the associat n to one office or banking house. *We are asked how- ever, to construe it otherwise in view of th rule that 'words, importing the singular number my be extended and be applied to several persons or tings.'* Rev. Stats. §1. *But obviously this rule is n one to be applied except where it is necessary to arry out the evident intent of the statute.* (Cita ons) . . . Here there is not only nothing in th con- text or subject matter to require the constr ction contended for, but other provision of the N ional Banking Law are persuasively to the cor rary. . . . This interpretation (singular) of the tute by the legislative departments and by the exe tive

officers of the government would go far to remove doubt as to its meaning if any existed. See *Tiger v. Western Investment Co.*, 221 U. S. 286, 309; *U. S. v. Hermanos y Compania,* 209 U. S. 337, 339." (Emphasis added.)

The manner in which the use of the singular for rtgage has always been joined with the plural for tes is not a matter of coincidence of inadvertence. t serves the very valid purpose of clearly indicating t which is understood in the commercial fields to stitute the security as distinguished from that which merely a mortgage. Not only is the SEC quotation the law misleading, but it has no application here the very reason that the use of the plural results a very obvious and necessary distinction which is roughly consistent with (1) the legislative history (2) the repeated and continuous acts of the regulatory ency over a period of 25 years and (3) the practice d understanding of the business community, particularly in the finance field where mortgages are used.

Since it was pointed out in my opening brief that e type of information required by the statute for gistration is information of a totally different charac- than that which is inherent in the description of a rtgage, SEC comes back with the answer that it es have some limited jurisdiction to change the items ich must be included in a registration statement, or plication therefore. The fact, however, that SEC has ver seen fit to so change the statutory format over period of some 27 years is very adequate proof that never contemplated, nor did the legislature ever conplate, that it be completely overhauled to fit the

format of a mortgage. Again, if mortgages were something new, it might be a different story, but they have been in existence in vast numbers during the entire history of the SEC statutes and over the 27 year period, SEC has never seen fit to, nor required to, in anywise change the format applicable only to securities which couldn't possibly fit a home mortgage.

C. Summary as to SEC's Deceptive Arguments That a Security Exists in the Instant Case.

Although SEC is forced to concede in its brief that unless it can show that investment contracts do exist in the instant case or the mortgages or trust deeds constitute securities, the SEC and the federal courts are without jurisdiction, it uses very circuitous and fallacious reasoning to try to becloud the issue and somehow arrive at the conclusion that a security exists.

First, regarding the obvious fact that a mortgage with all of its parts was never intended to be classed as a security is amply covered in my opening brief and the very fact that SEC could not come up with any plausible argument in rebuttal to this overwhelmingly legislative history and the practice of this very agency for 25 years is proof that it has no valid answer. Again, it must be realized that the mortgage industry itself is, if anything, larger than the security industry and has never been thought to be subjected to the regulations of the security field and SEC has no reason now to belatedly try to invoke the regulations of the security field in the home mortgage area. Coming so many years after enactment and admittedly being a test case it is obvious that the litigation regarding the SEC's expansion of its jurisdiction should be suspect and the agency should be required to show clearly why be-

ly claims this change and expansion of its bureaucratic powers. As has been shown, many of the trust deeds involved in the instant case do not have any note whatsoever connected with them [See DX AL] and this is true generally throughout the mortgage industry. Obviously it was never the intent of the legislature to permit the SEC to invoke jurisdiction merely because a permissible paper form was used in lieu of another type of stationery when irrespective of whether or not a note does or does not exist with the trust deed that it has the identical legal function, force and effect and is similar in all manners and situations. Thus, as has been shown where there isn't even a mortgage note incident to the mortgage itself [See DX AL], obviously the SEC's absurd argument that it can invoke jurisdiction over mortgages merely because of an incidental note must necessarily fall.

Next, SEC attempts to liberalize and substitute an indefinite, nebulous standard for that set up by the Supreme Court in the *Howey* case, *supra,* regarding the prerequisites of an investment contract. Rather than dutifully showing in detail how the subject matter of the trust deeds in the instant case comply with the definition of the Supreme Court, the SEC has fallen back on general language of an earlier and less precise case (*Joiner, supra*) which it is trying to use as a cover for its substitution of a very broad, general and improper definition of the term "investment contract". Since this has been discussed, *supra,* let me just point out by analogy what SEC is attempting to do. It is comparable to the situation where a person takes a *bull* and places upon it a sign reading "Horse", and shouts long and loud that indeed the animal is a horse. The

tenor of his argument is that it has many characteristics which are found in the horse such as two eyes, ears, a tail, 4 legs with hoofs, etc. Perhaps this type of argument might appeal to someone who just flew down from Mars, but any school child knows the difference between a bull and a horse, although most people would be hard put to define in careful detail the distinctions in the appearance of a bull and a horse. Nevertheless, the obvious distinctions do exist and are so generally recognized that any normal person could readily distinguish a bull from a horse, just as anyone in finance or business world could readily distinguish between a mortgage and a security, although many might be hard put as to defining why in careful detail they are different. Suffice it to say that the Congress, at the time of the enactment of the statute containing the definition here under construction, passed a similar bill covering the home mortgage field (see opening brief 11) should be proof enough that Congress never intended that the SEC bill to be an omnibus bill including everything which the SEC sought to invoke within their statutory language. Traditionally and now, throughout the business world, mortgages are thought of in an entirely different class from securities and this is obvious and universal, and it isn't any more surprising than the fact that our civilization regard bulls and horses as animals in entirely different classes. In short, SEC has failed to show how a traditional mortgage has, in the instant case, become a security as defined in the Supreme Court definition of an investment contract or the term security as contained in the Securities Act of 193.

II.

SEC Distorts Quotations of This Counsel.

ot only going into irrelevant and improper question-
n of this counsel, through the lower court, but also
e ing upon something which is not in evidence (SEC
r f 48) the SEC proceeds to rely upon part of a state-
n t made in a hearing before California State agencies
takes the statements of its context, thus distorting it
r misrepresenting its meaning. To disprove the SEC
n uence, I would have to go further beyond the record
r this would be improper. However, this is but one
n ance of the SEC tactics in this regard that were
r ularly used by SEC throughout the trial to dis-
t and pervert utterances of the defendants, so I
o iously have no singular reason for complaints. This
is highly technical field and loose and intermittent
q ting can totally distort the real context.

III.

S C Is Unable to Defend the Findings Other Than by Reference to Other Findings Rather Than Evidence.

or the reason that most of voluminous "findings" i this case are totally without foundation in the evi-
d ce, whenever SEC in its brief had to make a point or
d end an attacked "finding" it had to rely upon an-
o er "finding", thus having error breed up error, un-
t th upon untruth, and distortion upon distortion.
T s is particularly true of alleged misrepresentation

or fraud which were never established by evidence but repeated continuously at every opportunity and thus "proved."

WHEREFORE, appellants pray that the case be REVERSED for lack of jurisdiction.

Respectfully submitted,

PAUL J. FOLEY,

Attorney for Appellants.